(8)

Supreme Court, U.S.
FILED
APR 20 1988

No. 87-600

In the Supreme Court of the United States

OCTOBER TERM, 1987

VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

CHARLES FRIED
Solicitor General

LOUIS R. COHEN
Deputy Solicitor General

BRIAN J. MARTIN
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

EVA MARIE CARNEY
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether a contract written by a state-regulated insurance company may qualify under the "annuity contract" exemption to the Securities Act of 1933 if the contract guarantees the return of principal, guarantees payment of a fixed rate of interest, provides for the accrual of excess interest at rates set from time to time by the insurance company, and guarantees payment of any excess interest that accrues.

TABLE OF CONTENTS

	Page
Statement	1
Discussion	5
Conclusion	10

TABLE OF AUTHORITIES

Cases:

Marine Bank v. *Weaver*, 455 U.S. 551 (1982) 7
SEC v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) 3, 5, 6-7, 9
SEC v. *Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959) 3, 6, 7, 9

Statutes and regulations:

Internal Revenue Code, 26 U.S.C. (& Supp. III) 403(b) .. 1
Investment Company Act of 1940, 15 U.S.C. (& Supp. IV) 80a-1 *et seq.* 2, 6
Securities Act of 1933, 15 U.S.C. 77a *et seq.* 2
§ 3(a)(8), 15 U.S.C. 77c(a)(8) 3, 4, 5, 6, 8, 9, 10
§ 5, 15 U.S.C. 77e 6
Securities Exchange Act of 1934, 15 U.S.C. (& Supp. IV) 78a *et seq.* 3
§ 10(b), 15 U.S.C. 78j(b) 2, 5
§ 15, 15 U.S.C. (& Supp. IV) 78*o* 6
17 C.F.R.:
Section 230.151 ..... 3, 4, 5, 6
Section 240.10b-5 2

Miscellaneous:

American Council of Life Insurance, *1987 Life Insurance Fact Book Update* (1987) 5
Securities and Exchange Commission Release No. 33-6645, 51 Fed. Reg. (1986):
p. 20254 6
pp. 20254-20255 6
p. 20255 6
p. 20256 ..... 7, 10
p. 20261 9

In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-600

VARIABLE ANNUITY LIFE INSURANCE COMPANY, ET AL., PETITIONERS

v.

BEVERLY J. OTTO, ETC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. Respondent Beverly Otto brought this class action in the United States District Court for the Northern District of Illinois against petitioners Variable Annuity Life Insurance Company (VALIC), affiliated companies, and certain of their officers and directors. VALIC is a Texas stock insurance company subject to state insurance regulation (Pet. App. 12a). Respondent Otto alleged that petitioners defrauded her and other class members in connection with their participation in VALIC's Tax Deferred Investment Program.[1] Otto contended that certain con-

[1] One of the features of VALIC's program was that Otto's contributions were excluded from her gross income pursuant to Section 403(b) of the Internal Revenue Code (26 U.S.C. (& Supp. III)).

tracts offered by VALIC under this program are securities subject to the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240.10b-5). C.A. App. D at 16-17.

The specific contract between Otto and VALIC was termed a "fixed annuity." Under the fixed-annuity contract, VALIC promised to pay Otto the amount of her contributions (less modest administrative charges), plus interest accumulated at a compound rate of 4% per year for the first ten years and 3-1/2% thereafter (Pet. App. 38a, 2a-3a). Otto's contributions were placed in VALIC's general account and invested primarily in long-term debt instruments such as mortgages and bonds (*id.* at 3a, 38a).[2] The contract also provided that VALIC, in its discretion, could credit "excess interest" over the guaranteed rate. VALIC promised to pay any monies that it declared and credited to Otto's account as excess interest (*ibid.*; C.A. App. K at 4). At the end of the contract term, Otto was entitled to withdraw the accumulated funds or use them to purchase an annuity from VALIC at specified rates (Pet. App. 2a-3a; C.A. App. K at 5). Otto also had the right to withdraw her money at any time before the end of the contract term (C.A. App. J at 5).

2. The district court granted petitioners' motion for summary judgment. The court held that VALIC's fixed-

---

[2] VALIC also offers a variable-annuity contract that does not guarantee either the return of contributions or a rate of interest on contributions. VALIC's variable-annuity contract is registered as a security under the Securities Act of 1933, 15 U.S.C. 77a *et seq.* (Securities Act). Participants' contributions are placed into an account segregated from the company's general assets; the segregated account is registered as an investment company under the Investment Company Act of 1940, 15 U.S.C. (& Supp. IV) 80a-1 *et seq.* The value of a participant's variable account depends on the investment performance of the separate account portfolio (Pet. App. 38a).

annuity contract is not a security because it comes within the "annuity contract" exemption of Section 3(a)(8) of the Securities Act of 1933 (15 U.S.C. 77c(a)(8)) (Pet. App. 37a).[3] In so holding, the district court distinguished VALIC's fixed-annuity contract from the annuity contracts found to be securities in *SEC* v. *Variable Annuity Life Ins. Co. of America,* 359 U.S. 65 (1959) (*VALIC I*), and *SEC* v. *United Benefit Life Ins. Co.,* 387 U.S. 202 (1967). The district court concluded that, unlike the contracts in those cases, VALIC bore sufficient investment risk to qualify the contract under the Section 3(a)(8) exemption (Pet. App. 40a-41a).

3. The court of appeals initially affirmed. The court noted that, under VALIC's fixed annuity, participants were guaranteed a rate of return that "was not so low that * * * it placed the investment risk on the policyholder in a way substantial enough to make the fixed annuity a security" (Pet. App. 8a-9a). This conclusion, the court reasoned, was buttressed by recently promulgated Rule 151 of the Securities and Exchange Commission (the Commission) (17 C.F.R. 230.151). Rule 151 defines a "safe harbor" for entitlement to the "annuity contract" exemption (Pet. App. 10a).[4] Analyzing VALIC's fixed annuity under Rule

---

[3] That provision exempts: "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia" (15 U.S.C. 77c(a)(8)). The district court held that an insurance policy or an annuity within the meaning of Section 3(a)(8) does not fall within the definition of "security" under both the Securities Act and the Securities Exchange Act of 1934, 15 U.S.C. (& Supp. IV) 78a *et seq.* (Pet. App. 36a-37a & n.1). Otto has not challenged this holding.

[4] Rule 151 specifies a three-prong test for determining whether a contract falls within the "safe harbor." The annuity contract must (a) be issued by a corporation subject to the supervision of the state in-

151, the court incorrectly assumed that VALIC guaranteed for the life of the contract the rate of any declared discretionary excess interest. The court believed that VALIC's fixed annuity therefore satisfied the requirement of Rule 151 that an issuer guarantee that it will not modify the rate of excess interest more often than once a year (Pet. App. 13a).

VALIC informed the court of appeals that it had the absolute right to change the excess interest rate at any time. After that fact was brought to the court's attention, the court issued an opinion holding that VALIC's fixed annuity contract is a security. The court stated: "A claimed right to change established excess interest rates and to eliminate excess interest payments entirely *at any time* surely tends to shift the investment risk from VALIC to the plan participant" (Pet. App. 30a (emphasis in original)). The court held that, although the minimum interest rates guaranteed by VALIC exceeded the rates required by Rule 151, this guarantee did not place sufficient investment risk on VALIC to qualify the contract for the "annuity contract" exemption of Section 3(a)(8). The court concluded that "[t]o find otherwise we would have to overlook *entirely* any requirement for a guarantee of excess interest. To do

---

surance commissioner, bank commissioner, or any agency or officer performing like functions; (b) place sufficient investment risk on the issuer; and (c) not be marketed primarily as an investment. An issuer "shall be deemed to assume the investment risk" if (1) the value of the contract does not vary according to the investment experience of a separate account; (2) the contract guarantees the return of principal and interest credited thereto, and credits to net purchase payments and accrued interest a specified rate of interest at least equal to that required under the nonforfeiture law of the state in which the contract is issued or that set by the National Association of Insurance Commissioners; and (3) the issuer guarantees that any declared rate of excess interest will not be modified more frequently than once per year. 17 C.F.R. 230.151.

this would be to disregard completely one element contained in the investment risk test of the SEC's safe harbor Rule 151" (Pet. App. 31a (emphasis in original)).

DISCUSSION

This case presents an important issue concerning the definition of "security" under, and hence the reach of, the federal securities laws: whether a fixed-annuity contract that provides for discretionary excess interest and does not qualify for the "safe harbor" afforded by Rule 151 may nevertheless be exempt under Section 3(a)(8). We believe that the court of appeals' legal analysis is wrong. Accordingly, we believe that the Court should grant the petition for a writ of certiorari.

1. This case has caused great interest and concern in the insurance industry. The type of contract at issue here—a so-called fixed annuity with discretionary-interest features—is very common. An industry source states that, at the end of 1986, there were about 11 million such contracts in force nationwide. See American Council of Life Insurance, *1987 Life Insurance Fact Book Update* 16 (1987). This Court has not considered the "annuity contract" exemption since *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967). In the last 20 years, the insurance industry has marketed many new products that arguably fall within that exemption. These contracts are not all alike; thus this Court's decision will not necessarily resolve the application of the securities laws to all so-called fixed annuities. The Court's opinion could, however, provide valuable guidance to the lower courts and the industry as to the proper standards by which to judge these products.

The significance of this case is not limited to whether fraud claims will lie under Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)). If a fixed annuity with a discretionary-interest component is a security, it is subject

to the registration provisions of the Securities Act (15 U.S.C. 77e). Moreover, the insurance company and its agents must comply with the broker-dealer provisions of the Securities Exchange Act (15 U.S.C. (& Supp. IV) 78*o*), and the company may lose its "insurance company" exemption under the Investment Company Act of 1940 (15 U.S.C. (& Supp. IV) 80a-1 *et seq.*). For these reasons, we believe that this case warrants plenary review.

2. The reasoning of the court of appeals is unclear. The court's opinion on rehearing indicates that the court believed VALIC's fixed annuity failed to qualify as an "annuity contract" solely because the fixed annuity did not satisfy one element of the test set forth in the Commission's Rule 151—*i.e.*, that the excess-interest rate be guaranteed for at least one year. If that was the court's reasoning, it was mistaken. Rule 151 provides a "safe harbor" so that an issuer meeting the rule's criteria is reasonably assured that its contract falls within the statutory exemption. See Securities and Exchange Commission Release No. 33-6645, 51 Fed. Reg. 20254, 20254-20255 (1986). As a safe harbor, Rule 151 does not express the Commission's views on the outer limits of the exemption. Thus, an insurance company that offers "a contract that, for one reason or another, does not satisfy all of the rule's conditions may still rely directly on section 3(a)(8), albeit with no Commission assurance that the contract is covered by the section 3(a)(8) exclusion." 51 Fed. Reg. at 20255 (footnote omitted).

3. Whether VALIC's fixed annuity is an "annuity contract" within the meaning of Section 3(a)(8) should be answered by reference to *VALIC I* and *United Benefit*. Under those authorities—as well as the relevant announcements of the Commission—it is clear that the assumption of substantial "investment risk" by the insurance company is one crucial factor. See *United Benefit*,

387 U.S. at 211; *VALIC I,* 359 U.S. at 71; 51 Fed. Reg. at 20256. The relevant purpose of the securities laws is to ensure that investors in securities are fully and accurately informed about the issuer and the investment's relevant features, including its risks.[5] This protection is not needed if, inter alia, the insurance company assumes a sufficient share of the investment risk, which reduces the risk to the participant, who is also protected by state regulation of the insurance company. Even though the participant bears some degree of risk, the contract may qualify under the "annuity contract" exemption.[6]

VALIC assumed substantial investment risk under the fixed-annuity contract sold to Otto. VALIC guaranteed the return of principal; thus Otto and the class members did not bear the common investment risk that changes in the market will erode the investor's capital contributions. VALIC also guaranteed an interest rate of 3-1/2% or 4% on principal and accrued interest so that Otto knew that her contributions would produce some income. The value of Otto's account also did not vary according to the investment experience of a separate account. Moreover, VALIC

---

[5] Justice Brennan noted in his concurring opinion in *VALIC I* that "[t]he prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations [are] precisely what traditional state regulation is aimed at" (359 U.S. at 90-91). State regulation aims to assure that an insurance company will be able to meet its fixed-dollar obligations. Thus, a person who enters into a fixed-dollar contract with a regulated insurance company generally does not need the disclosures regarding an issuer's financial condition that are required by the Securities Act. Cf. *Marine Bank* v. *Weaver,* 455 U.S. 551, 558 (1982).

[6] *VALIC I* and *United Benefit* do not suggest that an issuer must assume *all* investment risk under a contract in order for the contract to come within the exemption.

guaranteed the payment of all monies it credited to her account (principal, interest, and excess interest) regardless of whether she surrendered the contract prior to the time when she could purchase an annuity. In other words, VALIC was bound to pay Otto the full value of her account whenever she decided to terminate her contract even if VALIC incurred costs in obtaining the necessary funds. Thus, under the terms of the contract, this important investment risk was not shifted to Otto if she surrendered the contract.[7]

Otto did have some investment risk under VALIC's fixed annuity. One of the fixed annuity's attractions undoubtedly was its excess-interest component. Indeed, the record shows that VALIC set a rate of 14-1/2% for deposits made in the third quarter of 1982. This rate was over ten points higher than the guaranteed minimum rate. Under the contract, Otto bore the risk that this excess-interest rate—or any other declared excess-interest rate—could be reduced or eliminated at VALIC's discretion.

Nonetheless, we believe that VALIC bore sufficient investment risk under the contract to meet the investment-risk criterion of Section 3(a)(8). The "annuity contract" exemption should not be limited to annuities with only guaranteed interest rates and no discretionary-interest component—a type of contact not commonly offered today. At least where, as here, a state-regulated insurer

---

[7] By contrast, some contracts contain a "market value adjustment" (MVA) feature. Such a feature shifts investment risk to a participant who wishes to terminate the contract, by "discounting" account value according to a specified formula usually keyed to prevailing interest rates. The purpose of an MVA is to avoid or minimize loss by an issuer that has funded its obligations by investing in long-term debt instruments and would otherwise be required to sell those instruments at a discount to pay the participant his full account value.

assumes all risk with respect to principal and with respect to an adequate fixed rate of interest, and guarantees payment of all discretionary excess interest declared under the contract, the investment-risk criterion is satisfied.

4. Investment risk is only one of the interrelated criteria for judging whether a contract is an "annuity contract" under Section 3(a)(8). Another factor is the manner in which the contract is marketed. See *United Benefit,* 387 U.S. at 211. To qualify for the exemption, the insurance company's marketing plan must be aimed at appealing to purchasers " 'on the usual insurance basis of stability and security.' " 51 Fed. Reg. at 20261 (quoting *United Benefit,* 387 U.S. at 211). A contract most likely will not qualify under Section 3(a)(8) if it is marketed "with *primary* emphasis on current discretionary excess interest, and the possibility of future interest" rather than "the product's usefulness as a long-term insurance device for retirement or income security purposes." 51 Fed. Reg. at 20261 & n.47 (emphasis in original). We express no opinion whether the record in this case was adequate at the summary-judgment stage to allow the lower courts to assess VALIC's fixed annuity under this marketing criterion.

Another factor in a Section 3(a)(8) analysis is whether the insurance company assumes a meaningful mortality or longevity risk. See *VALIC I,* 359 U.S. at 71. At a minimum, to assume a mortality risk the insurance company must guarantee in the contract that the purchaser may buy an annuity at specified rates. The mortality risk is meaningful, however, only if there is a reasonable possibility that a purchaser reaching retirement age would choose to annuitize at those rates. VALIC's fixed-annuity contract guaranteed annuity rates for Otto when she retires between ages 50 and 75. The lower courts,

however, did not find whether this guarantee was meaningful. The lack of a meaningful mortality risk is not necessarily a disqualifying feature. See 51 Fed. Reg. at 20256. But if VALIC's marketing tactics place the status of its fixed-annuity contract in doubt, VALIC's assumption of a meaningful mortality risk might nonetheless tip the balance in favor of a conclusion that the contract is an "annuity contract" under Section 3(a)(8). Because the record may be incomplete on this factor, as well as on the marketing factor, we cannot state whether VALIC's fixed-annuity contract is exempt from the federal securities laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

LOUIS R. COHEN
Deputy Solicitor General

BRIAN J. MARTIN
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ROSALIND C. COHEN
Assistant General Counsel

EVA MARIE CARNEY
Attorney
Securities and Exchange Commission

APRIL 1988

☆ U.S. GOVERNMENT PRINTING OFFICE: 1988—202-037/60404